Direct Dial: 020-7901

7437

9 August 2002

Transco, Shippers and Other Interested Parties

Our Ref:

Net/Cod/Mod/0554

Dear Colleague,

Modification Proposal 0554 'Introduction of a Negative Firm Overrun Charge'

Ofgem has carefully considered the issues raised in Modification Proposal 0554 *'Introduction of a Negative Firm Overrun Charge'*. Ofgem has decided not to accept the proposal because we do not believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background to the proposal

The entry capacity regime

Transco has allocated monthly system entry capacity ('MSEC') rights to access the National Transmission System (NTS) via six monthly auctions since September 1999. The next auction is due to commence on 16 August 2002 and will offer capacity for the six-month period commencing 1 October 2002. Transco also offers capacity day-ahead and within day, to the extent that it can physically make available such capacity.

Use-it-or-lose-it ('UIOLI') interruptible capacity is offered at the day-ahead stage. This product is intended to prevent possible hoarding of entry capacity by shippers. Transco releases UIOLI capacity based on its estimate of the level of MSEC that has been purchased by shippers but that Transco expects will not be utilised. The release of UIOLI capacity does not affect the rights of holders of firm capacity to flow against that capacity.

Where Transco determines in relation to any entry point that there is or will be a shortfall of capacity in relation to anticipated flows, it gives a notice to all holders of interruptible capacity at that entry point, specifying the effective time of curtailment of interruptible capacity and the interruptible curtailment factor (based on the size of the capacity shortfall) to apply. The extent to which a shipper's holding of interruptible capacity will be curtailed also depends on the effective time of curtailment. A shipper's holding of interruptible capacity that is curtailed will be reduced proportionately with the hours remaining in the day from the effective time of curtailment (for example, if a shipper held two units of interruptible capacity and interruptible capacity was curtailed at 6pm (ie half-way through the gas day), the shipper would have one unit of effectively firm capacity for that day).

To the extent that a capacity shortfall remains after curtailing interruptible capacity, Transco must buy back firm entry capacity rights at market prices. Transco has financial incentives to efficiently manage the costs of buy-backs. Following Ofgem's acceptance of Modification Proposal 0540, '*Delay of Licence and Effects on Capacity Incentives'* on 28 March 2002, new parameters were introduced to Transco's buy-back incentive with effect from 1 April 2002 to 31 March 2003. Under this incentive Transco faces a £35 million target level of net buy-back costs and is rewarded for performance below target and penalised for performance above target. Transco's possible revenues and costs under this incentive are subject to a cap of £30 million and a collar of £12.5 million.

Overrun charges

Shippers have strong commercial incentives to purchase entry capacity before flowing gas. Shippers who flow gas in excess of their total capacity rights (both firm and interruptible) are subject to overrun charges. The overrun regime is intended to ensure that the costs of a participant overrunning are targeted back to that participant. The current overrun charge is set equal to the higher of:

- 1.1 times the weighted average price by volume of the top 25% accepted bids for daily capacity;
- 1.1 times the highest accepted offer price on that day to sell capacity back to Transco; and
- 8 times the daily rate for MSEC.

A shipper's holding of firm entry capacity may become negative where a shipper trades entry capacity or sells capacity back to Transco in excess of its holdings of entry capacity. To the extent that a shipper's total holdings of both firm and interruptible entry capacity is less than zero at the end of a gas day, it is charged an overrun charge to the extent of the negative holding.

The Gas Balancing Regime and interactions with the capacity regime

Ofgem has expressed concerns in the past that within-day input profiling of gas onto the NTS may result in Transco having to curtail interruptible capacity as Transco is unable to make the capacity it has sold on the basis of implied flow rates physically available during the gas day. In particular, under the existing daily balancing regime interruptible capacity holders may have their rights curtailed and the volume of firm capacity buy-backs is potentially increased as a result of the failure of some shippers to flow at uniform flow rates. Ofgem has previously expressed concerns that this may undermine the usefulness of the UIOLI interruptible capacity product.

In this context, in its decision on modification 0478, *'Re-installing interruptible capacity within-day'*, Ofgem suggested that industry participants should give consideration to developing measures that seek to improve the targeting of the costs associated with variations in within-day flows against capacity holdings. Ofgem indicated that this could include the development of within-day overrun charges that are determined on the basis of deemed flows at individual terminals where shippers hold capacity with each shipper's end of day capacity rights being divided into hourly units.

In February 2002 Ofgem published revised proposals for the reform of the gas balancing regime, which took into account respondents' comments on Ofgem's February 2001 proposals. Ofgem proposed a framework for reform that contained three main elements, namely:

- Shorter balancing periods than one day, to reflect the period within which Transco's system can safely manage profiled flows and to allow more effective targeting of costs through cash-out of the costs incurred by Transco in balancing the system within-day;

- The sale of system linepack to allow shippers to manage their imbalances across a number of balancing periods; and

- Improved commercial incentives to provide better information to Transco of intended gas flows.

As part of the process of reforming the gas balancing regime Transco has raised modification proposal 0513 '*Reform of Energy Balancing Regime'*. Under this proposal a Network Code review group has been established to consider the operation of the gas balancing regime and whether any changes to the regime should be made to address the problems that have been identified. The group is due to release its final report shortly.

The proposal

This modification proposal provides for a new charge that would be applied to shippers that end the day with a negative holding of firm capacity rights. This new overrun charge would be in addition to the standard overrun charge levied if a shipper's gas allocation exceeds its net capacity holding. It would apply on a 'greater of' basis with the existing negative overrun charge. In Transco's workstream report, it explained that it would take the highest volume identified by the present negative overrun charge or the proposed negative firm overrun charge. The price used would be the same price as that used for the existing overrun charges and any revenues would be treated in the same way as other revenues from overrun charges.

Transco proposed to apply this charge from 1 October 2002.

Respondents' views

Ten responses were received on this modification proposal, with support and opposition to the proposal fairly evenly divided. However, a number of respondents supporting the proposal qualified their support.

One respondent supporting the proposal agreed with Transco that the 'creation of virtual firm capacity' might lead to a higher level of buy-back costs as the total amount of capacity that Transco needs to buy back may be higher. Another indicated that it should inhibit shippers from accessing interruptible products and treating them as firm, which should reduce the costs to the industry by potentially reducing the requirements on Transco to buy back capacity.

Some respondents commented on the effect of the proposal on demand for firm capacity, with a number of respondents stating that the proposal would be likely to increase the demand or increase competition for firm capacity.

A number of respondents commented on whether the issue Transco had identified was a genuine problem or not, and if it was a genuine problem, whether the solution proposed addresses the problem.

One respondent, while offering reluctant support for the proposal, was not totally convinced that negative end of day firm capacity holdings cause problems. It suggested that if this proposal is implemented, it should be made transitional, with Transco monitoring and reporting on the effect of the proposal.

One respondent stated that the proposal incentivises shippers to ensure that their end of day firm capacity holding is not less than zero, but does not prevent shippers from trading interruptible capacity as firm and causing buy-back costs.

Two respondents suggested an alternative solution to the problem Transco had identified. These solutions would limit the amount of interruptible capacity shippers held on a day. One respondent suggested reducing the capacity entitlement of shippers when trading interruptible entry capacity within day. The respondent suggested that this would prevent shippers from selling interruptible capacity as firm with the shipper's entitlement being reduced upon the passing of each hour. The respondent indicated that this alternative is an improvement upon the modification proposal, which it suggested failed to appropriately target the buy-back costs upon the relevant participants trading the capacity by permitting the shipper to purchase firm capacity by the end of the day and avoid the overrun charge. Another respondent suggested that Transco could force shippers to sell back any interruptible capacity that it had not used at a particular time in the day. However, this respondent felt that this would be only a small step towards resolving the problems it believed existed with the buy-back regime, including the proper targeting of buy-back costs.

One respondent opposing the proposal stated that interruptible capacity should be treated as firm up until the point at which an interruption notice is issued. This shipper commented that if the primary shipper holds the capacity and flows against it then it will be deemed firm, however if the capacity is transferred then the modification provides for it to be viewed in a different way. The shipper stated that if interruptible capacity has already elapsed it should be deemed firm irrespective of who is the registered owner.

These concerns were shared by another respondent which also stated that interruptible capacity that has been used prior to interruption has effectively become a firm holding and it is unjust to penalise a shipper for flowing against an un-interrupted capacity holding. This respondent indicated that the proposal was a crude measure to address the issue of apportionment of capacity throughout the day and has broader implications that require wider industry review.

Some respondents suggested that Transco should potentially be managing interruptible capacity more proactively by addressing the volumes of interruptible being released to the market and in scaling back that capacity.

One respondent suggested that this proposal would allow Transco to make more money under its buy-back incentive by ‘sterilising’ within-day capacity without recourse to buy-back actions. This shipper indicated that the proposal discriminates between different shippers depending on the manner in which they choose to manage their capacity and overrun risk.

One respondent indicated that the proposal would adversely affect the liquidity of any secondary markets for entry capacity.

One respondent expressed concern with the timing of this proposal, given the upcoming MSEC auctions. It opposed any changes to the arrangements for the next set of auctions that are decided after the auction has been held. These comments were based on a 5 August 2002 auction start date.

Transco’s view

In Transco’s modification proposal, it stated that it is aware that a number of shippers have traded more firm entry capacity than they hold, using interruptible capacity to ensure that they maintain a positive end of day capacity holding. Transco claimed that this activity effectively increases the total quantity of firm capacity beyond that released by Transco, because the accrued rights for interruptible capacity cannot be scaled. For example, at 18:00 within a gas day, a shipper's end of day interruptible capacity holding cannot be reduced by more than 50%. It therefore argued that shippers are effectively able to trade interruptible capacity as a firm product.

Transco stated that this situation potentially results in an increased level of firm capacity and therefore an increased buy-back requirement if constraints arise, leading to higher costs for both shippers and Transco. It stated in its final modification report that, if interruptible capacity is not used in the early part of a gas day, then accrued rights could safely be sold on as firm capacity in the later part of the same gas day. In the event of flows turning up mid-way through a day which necessitates capacity management activity on the part of Transco, Transco argued that a greater quantity of firm capacity buy-backs might be required because interruption is not a practical solution for managing accrued capacity rights.

Transco considers that its buy-back incentive is set on the basis of the baseline quantities of firm capacity that it is required to offer to shippers. If the stock of firm entry capacity can be further increased beyond that increased by Transco, it argues that this may potentially increase buy-back costs.

While Transco agreed with a respondent that a form of hourly capacity management could be introduced, it considered that the scope and implications of such a change are large, whilst the problem is comparatively small. It believes that this proposal offers a more measured solution that can be introduced at lower cost.

In Transco's opinion, this proposal would increase the efficient and economic operation of the entry capacity regime because it discourages the creation of firm capacity beyond that released in Transco's primary allocation.

Transco anticipates that the systems developments necessary to implement this proposal could be delivered at the beginning of December 2002, to be included in the October overrun invoice.

Ofgem's view

Ofgem considers that the problem that Transco has identified with this proposal relates to the absence of a sub-daily balancing regime and the absence of any sub-daily capacity management methodology that efficiently targets the costs associated with variations in within-day flows against capacity rights (with these rights potentially being divided into sub-daily quantities (eg hourly quantities)).

Ofgem considers that this combination of factors contributes to enabling shippers with interruptible capacity holdings that are interrupted part way through the day to successfully sell on these accumulated rights as firm or 'accumulated firm' capacity rights and as a result, take on negative firm entry capacity positions at the end of the gas day. Ofgem agrees that these factors could in some circumstances effectively increase the volume of capacity that Transco needs to buy back to effectively manage constraints at entry.

Nevertheless, Ofgem does not consider that this proposal is an appropriate or effective means of addressing Transco's concerns.

In particular, Ofgem does not consider that the proposal will necessarily address the problem that Transco has identified. For example, the proposal would not prevent a shipper from using its own interruptible capacity as accumulated firm capacity for itself rather than trading the capacity. In these circumstances, shippers could effectively avoid the overrun charge by trading gas at the NBP rather than selling on 'accumulated firm' entry capacity. In this respect the proposal would simply be limited in its effect to penalising those who trade capacity.

For these reasons, Ofgem is not satisfied that the proposal would address the behaviour that Transco has identified as possibly causing it to buy back capacity rights. As such Ofgem is not satisfied that Transco has demonstrated that the proposal would better facilitate the efficient and economic operation of Transco's pipeline system.

Ofgem considers that Transco's concerns regarding the impact of variations in within day flows on the capacity regime are fundamentally linked to the problems that have been identified with the gas balancing regime and should be addressed in this context.

Ofgem's decision

For the reasons outlined above Ofgem has decided to direct Transco not to implement this modification proposal because we consider that it does not better facilitate the relevant objectives, as outlined under Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Lyn Camilleri on 020 7901 7431.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements